Pre-Budget 2020 Statement

September 2019

Irish Fiscal Advisory Council

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Non-Technical Summary

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The domestic economy continues to perform strongly and risks overheating. Yet the international economic outlook has deteriorated in recent months. While the situation is volatile and evolving, risks of a hard Brexit are high.

Ireland's net debt ratio is the sixth highest in the OECD at close to 90 per cent of national income. And the pace of government spending increases has been fast in recent years, accelerating from 4.9 per cent in 2015 to 6.7 per cent in 2018. This partly reflects large in-year spending increases over and above what had been budgeted for, including in Health.

Government revenues have been boosted by unexplained corporation tax and a strong bounce back in the economy. These gains are likely to prove temporary. Corporation tax receipts accounted for a record 18.7 per cent of taxes in 2018 and carry a lot of risks. Recognising these temporary gains, the underlying budget balance would appear to have deteriorated since 2015.

Further spending slippages are likely to happen again in 2019. Another Health overrun, the payment of the Christmas bonus, and underestimated social payments could mean spending €1.3 billion higher than previously budgeted this year. Repeating the pattern of slippages would be inappropriate. It could add to further overheating pressures and reduce scope for budgetary policy to support the economy in future.

The Government must deliver on its spending plans for 2019. If spending overruns occur, the Government should find offsetting savings in other areas. It should not rely on further surges in corporation tax receipts, which could prove unsustainable, to fund slippages.

For 2020, the Government should stick to its plans for a €2.8 billion budgetary expansion compared to the planned 2019 level. This would mean a budget day package of €0.6 billion, given that €2.2 billion is already pre-committed.

The €2.8 billion expansion would be slightly below the sustainable growth rate of the economy. It would also reflect risks of a disorderly Brexit, the reliance on corporation tax, possibilities of overheating, and the rapid rise in spending between 2017 and 2019. There is a case for more caution given the risks of Brexit and the worsening global outlook. If spending overshoots in 2019, the government should scale back its pre-commitments for 2020.

Brexit could mean severe budgetary costs. A large budget deficit could emerge due to falling taxes and rising unemployment-related costs. This is even before potential customs infrastructure and supports to hard-hit sectors are considered. The Government might need to cut spending or raise taxes to prevent debt ratios from rising. Measures to deal with the costs of a hard Brexit should, however, be accommodated as far as possible.

The Council has repeatedly criticised the Government's medium-term plans for not being credible. The Minister has noted that some of the concerns raised by the Council are being explored. The Government should follow through on indications that it will develop a more credible medium-term plan in time for *Budget 2020*.

Key Messages

The international economic outlook has deteriorated in recent months. While the situation is volatile and evolving, the risks of a hard Brexit are high. Advanced economies are already in a mature phase of the current cycle and there are signs that growth in the US, UK and Euro Area is slowing. Furthermore, a harder-than-previously-expected Brexit now looks increasingly likely. Notwithstanding the risks of an external shock, the domestic economy continues to perform strongly and risks overheating if major shocks do not materialise. Some sectors could continue to outperform and potentially overheat (such as building and construction), even if others are severely affected by Brexit (such as Agri-Foods).

Ireland's net debt ratio is the sixth highest in the OECD. When set against an appropriate measure of national income like modified GNI*, Ireland's net debt burden is 89.9 per cent at end-2018, the sixth highest in the OECD below France, Portugal, Italy, Japan and Greece.

The pace of spending increases in recent years has been fast. The pace of annual spending growth has risen from 4.9 per cent in 2015 to 6.7 per cent in 2018. The acceleration partly reflects large within-year spending increases over and above what had been budgeted for, including in Health.

The underlying budget balance excluding interest costs appears to have deteriorated since 2015. Revenue growth has been strong in recent years. But this reflects the strong cyclical recovery and surges in corporation tax receipts. Much of the recent improvement in revenues is therefore likely to prove temporary.

Corporation tax surges mean that receipts are at record levels and this has masked repeated spending overruns. Corporation tax receipts accounted for a record 18.7 per cent of tax receipts in 2018. The practice of using corporation tax outperformances to achieve budget balance targets carries significant risks. These revenues are more volatile and unpredictable than other sources of Government revenue. They are also subject to potential reversals in future years, depending on firm-specific developments and changes to the global tax environment. By contrast, most of the new expenditure measures being funded by these receipts are likely to be long lasting.

Within-year spending increases—above and beyond previous plans—look set to occur again in 2019. Health spending looks likely to overrun this year (overruns have averaged €0.5 billion in recent years) and the Christmas bonus has not been provided for but is likely to be paid (estimated to cost €0.3 billion). In addition, the base level of spending on social payments in 2018 was higher than expected, though official forecasts for 2019 were not revised up accordingly. This could mean an upward revision of €0.5 billion to general government spending in 2019. Taken together, general government spending in 2019 could turn out, on this basis, to be as much as €1.3 billion higher than previously budgeted.

These slippages would repeat the pattern of within-year increases observed in recent years and would be inappropriate. They would imply a looser fiscal stance and contribute to further overheating pressures. They would also reduce the scope for budgetary policy to support the economy further in the event of an adverse shock materialising in the near future.

For 2019, the Government must deliver on its spending plans. Existing plans should be met and offsetting savings found in other areas if spending overruns occur. This means that "supplementaries" (additional spending allocations to Departments for the current year) should be avoided or overruns offset with savings in other areas. Making larger than planned spending increases this year reduces the scope for planned increases in 2020.

The Government should not rely on further surges in corporation tax receipts, which could prove unsustainable, to fund more slippages. Corporation tax receipts were strong in the key month of June this year, and are likely to experience a further overperformance for 2019 as a whole. It is possible that a further overperformance could mask the effort of any spending slippages on the budget balance in 2019 as has happened in recent years. However, there is considerable uncertainty around these receipts and the budget balance could be much worse for 2019 if an overperformance does not materialise.

For 2020, the Council assesses that the Government should stick to its plans for a €2.8 billion budgetary expansion compared to the planned 2019 level as set out in the *Stability Programme Update (SPU 2019)*. This increase would be consistent with previous plans and slightly below what would be implied by the sustainable growth rate of the economy. The assessment reflects the risks associated with a disorderly Brexit, the reliance on corporation tax, possibilities of overheating, and the rapid rise in spending between 2017 and 2019. There is a case for more caution owing to the risks associated with Brexit and the worsening outlook for the external environment.

While Brexit could entail further budgetary costs, depending on the outcome, the Government should offset these slippages in core spending with other budgetary measures elsewhere in 2019 or in 2020.

If spending overshoots for 2019, this would reduce or eliminate the space for any new measures on Budget day and the government could need to scale back pre-commitments for 2020 to achieve this objective. Additional spending or tax measures would need to be financed by spending or tax measures elsewhere. Targeted measures to address the transition costs related to a hard Brexit should, however, be accommodated as far a possible together with any associated shortfalls in revenues or increases in social spending. It is worth noting that the Government is already increasing spending at a fast pace even before additional measures associated with Brexit are considered.

Trade-offs in a severe Brexit outcome could be very challenging. If there is a disorderly Brexit, then outcomes could be materially worse than is currently planned and budgetary costs will be higher. Should a more adverse shock materialise, the policy response would need to be carefully assessed. However, the Government should in principle support the economy during any period of unusually weak demand. A large budget deficit could emerge due to falling tax receipts and rising unemployment-related costs even before potential customs infrastructure and sectoral supports are considered. The Government might need to cut spending or raise taxes to prevent debt ratios from rising indefinitely.

The Government should follow through on indications that it will develop a more credible medium-term plan in time for *Budget 2020*. The Council has repeatedly criticised the Government's medium-term plans for not being credible. This is due to its forecasts relying on technical assumptions that entail implausibly low spending growth in later years, a lack of a medium-term anchor for net spending increases, a poorly developed debt ratio target, and no clear plan to set aside excess corporation tax receipts. The Minister has noted that some of these issues will be explored by the Department with recommendations to be put to the Government in autumn. Changes to medium-term spending forecasts made in the *Summer Economic Statement 2019* make them more plausible, but they still rely on arbitrary assumptions rather than the likely path for spending. The Council has a number of suggestions as to how to address these and other weaknesses, including the development of a Prudence Account to save excess corporation tax receipts.

Pre-Budget 2020

Statement

1. Introduction

The Fiscal Council's mandate includes assessing the prudence of the Government's fiscal stance.[1] The basis for the Council's assessment is twofold: first, the Council conducts an economic analysis, which assesses the appropriateness of the fiscal stance in terms of the principles of sound economic and budgetary management; second, the Council assesses whether the Government's fiscal plans are in line with the requirements of the budgetary framework.

This *Pre-Budget 2020 Statement* reviews the fiscal stance in advance of *Budget 2020* in line with these aspects of the Council's assessment. Since the Council's *Fiscal Assessment Report June 2019*, the Government has published its *Summer Economic Statement 2019* (*SES 2019*); a *Mid-Year Expenditure Report 2019*; the *Annual Report on Public Debt in Ireland 2019*; papers on tax policy options from the Tax Strategy Group; and a number of papers exploring various public expenditure areas as part of the annual Spending Review process.

[1] The Council's mandate is set out in the Fiscal Responsibility Act (2012).

2. The Macroeconomic Context for the Budget

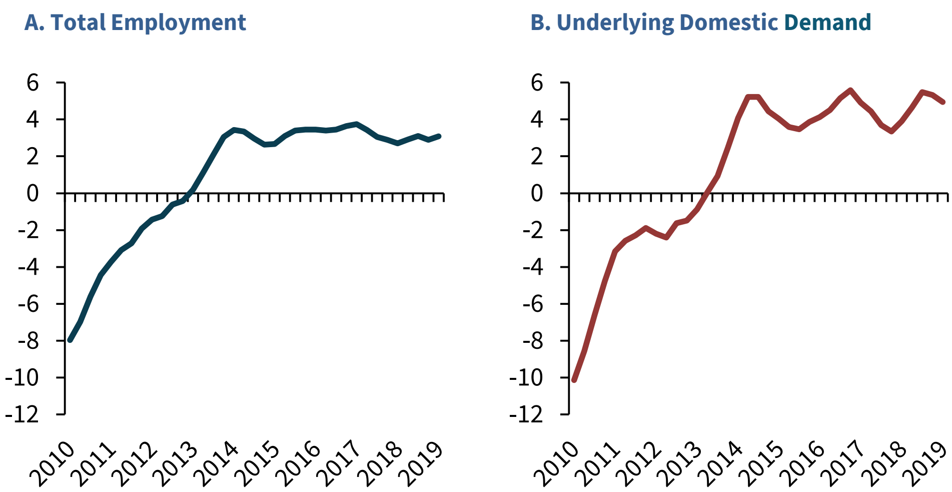
In June, the Council assessed that the macroeconomic outlook for the Irish economy was unusually uncertain and the outlook balanced between very different outcomes (*Fiscal Assessment Report, June 2019*). Continued signs of strength in the outlook for the domestic economy suggest that possible overheating could emerge in the near term. Yet various potentially-damaging shocks to the economy are brewing elsewhere. Since the Council's report in June, external developments have weakened and the likelihood of a disorderly Brexit has risen.

Recent Domestic Economic Activity

The labour market has proven a reliable indicator of domestic activity in recent years, and its strong performance since 2013 shows little sign of slowing. Total employment grew by 2.9 per cent in 2018 and by 2.8 per cent for the year to date, in line with annual growth rates seen since 2013 (Figure 1A).

Figure 1: The Domestic Economy Continues to Fare Well

% change (year-on-year)



Sources: CSO; and Fiscal Council workings.
Note: Four quarter moving averages are shown. Underlying domestic demand is consumer spending plus investment plus government consumption, but it excludes investment in intangibles and aircraft, which are mostly offset by corresponding imports and which are not deployed against domestic labour.

Underlying domestic demand looks through most distortions arising from foreign-owned multinational enterprises and is a useful measure, albeit that it excludes net exports (Figure 1B). This also points to a sustained strong pace of growth in the domestic economy over the past six years and up to the first quarter of 2019.[2]

One channel through which Brexit-related impacts are already affecting the domestic Irish economy is via the euro/sterling exchange rate. As of August, sterling had lost 21 per cent of its value relative to its 2015 average.

The Cyclical Position

With the domestic economy growing continuously for about six years now, most plausible estimates would suggest that the economy is currently close to its potential. The Council's own range of estimates suggests that the economy is operating at or slightly above its potential in 2019 (Fiscal Council, 2019a).

There are unusual uncertainties about the outlook for the domestic economy in the coming years and two potential scenarios are worth considering. One is that the domestic economy continues to operate above its potential for the period 2020–2023 and risks overheating.[3] This scenario relies on a soft Brexit scenario. The Government's latest official forecasts assume a transition period begins in 2019 and lasts until end-2020, with a free trade agreement reached with the EU thereafter. However, a second scenario—one that is now highly likely—is that a harder-than-expected disorderly Brexit scenario materialises. This would have adverse impacts on specific sectors of the economy most exposed to trade with the UK, on business investment and consumer spending, and it would potentially have negative implications for the financial sector. Such an outcome might be challenging to mitigate through available policy levers and it would partly reflect a permanent shock to Ireland's supply-side that would not be possible to alleviate indefinitely.

It is worth bearing in mind that the current cyclical upswing has been running for about six years. Looking just at employment cycles, upswings in Ireland have tended to last on average about 4½ years. Of course, economic cycles have irregular durations and this is especially relevant for Ireland. Given its highly open nature, Irish cycles are relatively more exposed to fluctuations in the world economy than to

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[2] Underlying domestic demand is consumer spending plus government consumption plus investment excluding intangibles and aircraft investment.

[3] See Box A of the *June 2019 Fiscal Assessment Report* for a discussion of "sustainable output" growth, which relates to the concept of overheating.

domestic cyclical fluctuations, which may otherwise repeat with greater regularity. A better way to view the likelihood of a future economic slowdown may be in terms of the extent to which there are imbalances in the economy or the probability of an external negative shock occurring (Fiscal Council, 2018a).

Risks to the Outlook

In June, the Council assessed that the risks to the Department's central forecasts were relatively balanced though there was unusual uncertainty about the outlook for the economy. Yet external developments have weakened of late.

The likelihood of a negative external shock occurring in the near term has risen. With advanced economies already in a mature phase of the current cycle, there are signs that growth in the US, UK and Euro Area is slowing. A harder-than-expected Brexit also looks more likely. Elsewhere, protectionist measures—most notably between the US and China—are dampening global trade prospects and potential changes to the international tax environment cast a shadow on Ireland's ability to continue to attract and retain foreign direct investment. Financial developments, including in Italy, also pose risks of adverse spillovers to other economies.

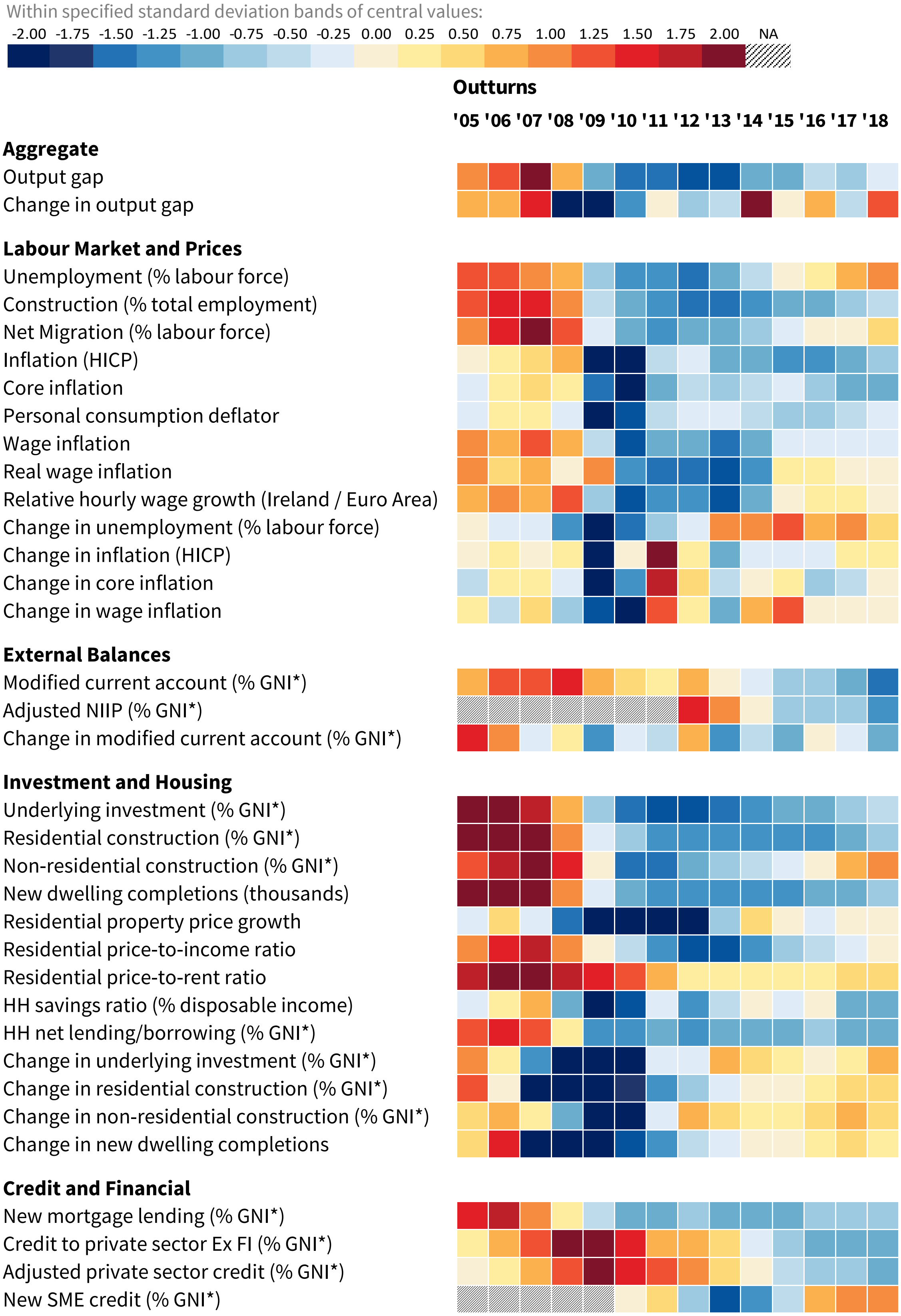
The unusual uncertainty surrounding the current macroeconomic situation in Ireland reflects the fact that—while risks of an adverse external shock may be high—the domestic economy has continued to outperform expectations. If a hard Brexit were to be avoided, and external developments were to be favourable, then Ireland could well face the prospect of overheating in the coming years. The labour market has tightened considerably and there is a reasonable possibility that housing completions could rise faster than expected if external conditions were to remain benign. The Government's official forecasts, based on their recently developed methodology, suggest overheating over the forecast horizon. The output gap is forecast to rise from 0.2 per cent (in terms of actual output relative to its potential) this year to 1.8 per cent by 2023.

The Council monitors imbalances in the economy carefully to assess the sustainability of the public finances. The "heat map" (Figure 2) is a useful summary tool for highlighting some of the indicators that the Council monitors.[4] These indicators reinforce the view that the economy is near its potential (with an output gap close to zero). The tightening labour market, high non-residential construction, and rising net inward migration flows are balanced against other indicators that do not currently indicate overheating pressures. Inflationary pressures have been relatively muted to date, housing completions remain below estimated annual requirements, credit conditions are relatively soft, and external balances are quite positive (with high household savings rates and improved balance sheets).

While evidence of overheating at present is limited, the trajectory of the economy suggests that it is headed in this direction absent any major external shock materialising or policy measures that dampen demand. Conditions can change quickly, with wage pressures tending to build up quickly in Ireland when overheating occurs. At low unemployment rates, wages have experienced rapid increases in the past (Linehan *et al.*, 2017). Hourly wage growth accelerated in 2018 and in early-2019 (for the last four quarters to Q1 2019, year-on-year growth in average hourly compensation per employee has averaged 2.6 per cent).

[4] There are two caveats worth noting in relation to the heat map: (1) it is very mechanical in nature and it may fail to adequately account for structural shifts; and (2) it is particularly challenging to identify appropriate equilibria or norms for each of the indicators included.

Figure 2: Heat map of potential imbalances in the Irish economy



Sources: CSO; Central Bank of Ireland; Department of Environment, Heritage and Local Government; ESRI/PTSB; European Commission (AMECO and CIRCABC); Residential Tenancies Board; and Fiscal Council workings.

3. The Fiscal Context for the Budget

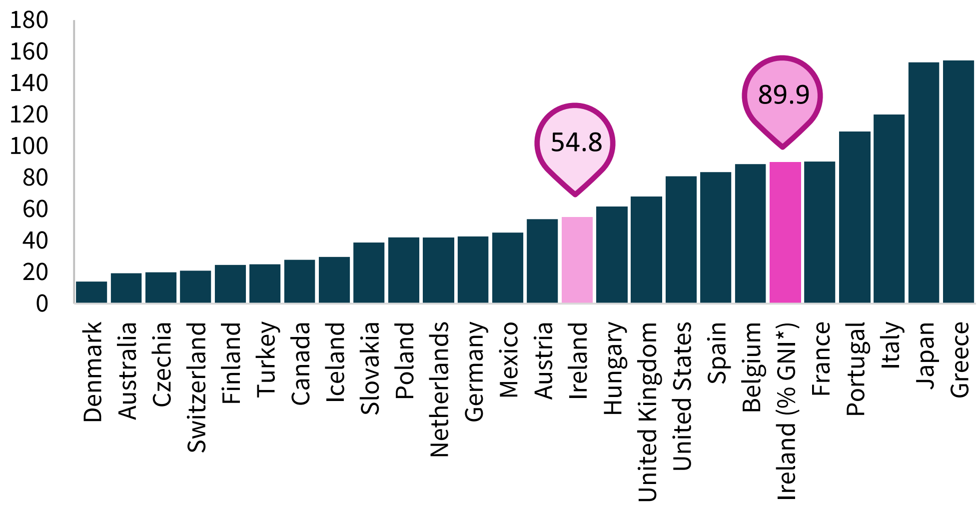
Ireland's government debt burden remains one of the highest in the OECD. Progress in terms of reducing this debt burden has been slower than it might have otherwise been. This is due in part to large unplanned spending increases since 2015, which were not offset by savings in other non-interest spending areas or funded by additional revenue-raising measures.

Government Debt

While measuring 55 per cent of GDP at end-2018, Ireland's net debt burden is 89.9 per cent—the sixth highest in the OECD— when set against a more appropriate measure of national income like GNI*. This puts it below France, Portugal, Italy, Japan and Greece (Figure 3).

Figure 3: The Largest 25 Net Debt Ratios in OECD Countries

% GDP (and % GNI* for Ireland), end-2018, general government net debt



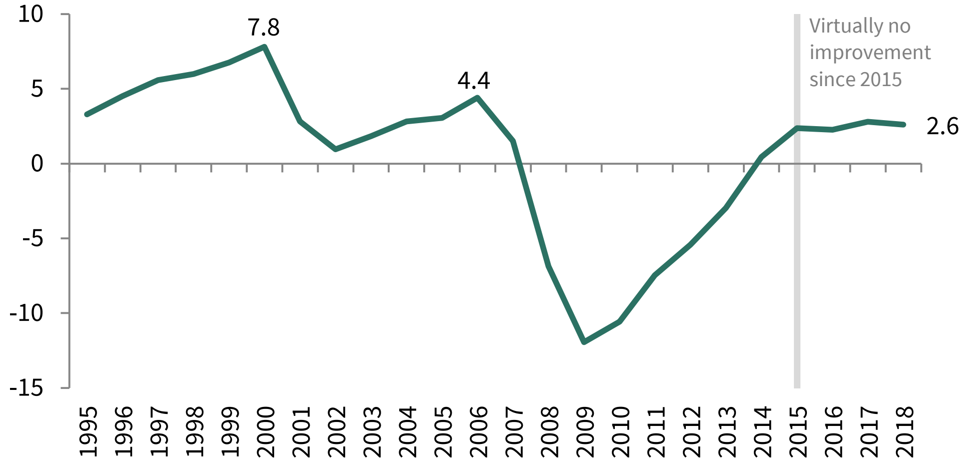
Sources: IMF (April 2019 WEO); CSO; Eurostat; and Fiscal Council workings.
Notes: The Stability and Growth Pact criterion of a 60 per cent ceiling for government debt is set in gross terms rather than in net terms. Also, the net debt measure does not account for the State's bank investments or any other equity holdings. It is financial liabilities in currency, loans and bonds less assets in the same instruments.

Government Balance

Successive efforts to bring a large deficit down in the initial post-crisis period proved successful. Yet, in recent years, the Government has used most of the proceeds of a cyclical upswing; reduced interest costs; and unexpected—and possibly temporary—surges in corporation tax since 2015 to increase spending at a faster-than-planned rate. Ignoring interest costs, the Government primary balance has barely improved since 2015 and it remains lower than the primary surpluses previously run in the 1990s and 2000s (Figure 4).

Figure 4: The Government Balance Excluding Interest Costs has not Improved Since 2015

Primary Balance (% GNI*)

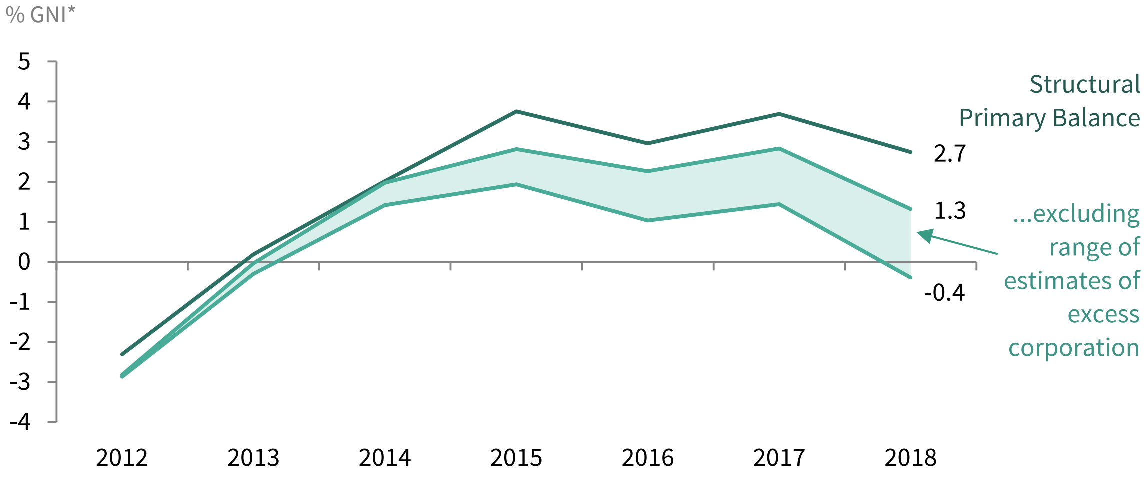


Sources: Department of Finance; and Fiscal Council workings.
Note: One-offs are also excluded from the balance shown.

Looking through the cyclical effects, the underlying structural position—as shown by the structural primary balance—would appear to have deteriorated since 2015 from almost 4 per cent of GNI* to slightly below 3 per cent in 2018 (Figure 5).[5] If we exclude corporation tax receipts unexplained by the underlying performance of the economy since 2012, then the structural primary balance could have deteriorated even more since 2015 to underlying levels as low as in the range of –0.4 to +1.3 per cent.

[5] Note that the Fiscal Responsibility Act (2012) formally interprets the government "fiscal stance" as the change in the annual structural balance of the general government, excluding interest payments.

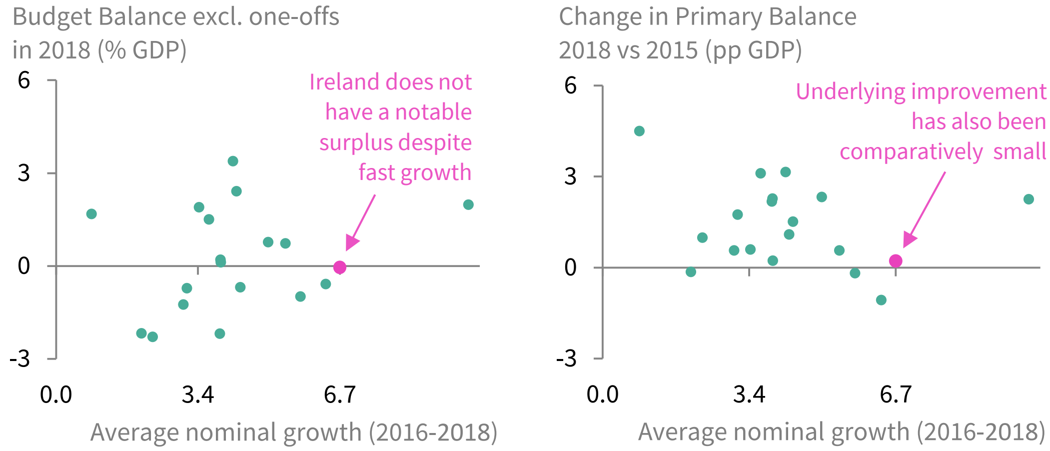
Figure 5: The Structural Primary Balance has Deteriorated Since 2015



Sources: Department of Finance; and Fiscal Council workings.
Note: The estimated "excess corporation tax" receipts are the same as in Box B of the June Fiscal Assessment Report (Fiscal Council, 2019a). Estimates are shown as a percentage of potential modified GNI*, which is obtained using the Department's preferred output gap estimates.

While Ireland has achieved a broadly balanced budget, other Euro Area countries are running surpluses despite weaker growth and without the same level of surges in corporation tax receipts (Figures 6 and 7). Of the 19 Euro Area countries, ten ran surpluses when one-offs are excluded in 2018. Of these, all but one had slower average nominal growth than Ireland over the period 2016–2018.

Figure 6: Ireland does not have notable surplus despite fast growth



Sources: Eurostat; CSO; AMECO; and Fiscal Council workings.
Notes: Data for Euro Area Member States are shown. Nominal GNI* is used instead of GDP for Ireland's budget balances and nominal growth rates. One-off items are excluded from budget balances.

From 2015 to 2018, 14 Euro Area countries have had larger improvements in their primary balance (excluding one-offs) than Ireland. Aside from Malta, all of these had lower nominal growth than Ireland from 2016 to 2018. With Austria showing a similar improvement to Ireland over this period, the only Euro Area countries Ireland has outperformed in terms of changes in the primary balance excluding one-offs are Italy, Latvia and Estonia.

In 2018, Ireland ran a marginal surplus for the first time since 2007. This owes much to efforts to restore the public finances after the crisis up until 2015. But improvements since then have been slower than would have been expected, given the boost to receipts from the cyclical upswing, falls in interest costs and surges in corporation tax. Excluding one-offs in 2018, a marginal deficit remained.

Figure 7: Large surpluses run elsewhere in 2018

% GDP (% GNI* for Ireland), General Government Balance

Sources: Eurostat; CSO; AMECO; and Fiscal Council workings.
Notes: Data for Euro Area members are shown. Nominal GNI* is used for budget balances for Ireland. One-offs are excluded (for Ireland, one-off corporation tax receipts of €350 million and a one-off payment of €213 million for the settlement of medical consultants' pay arrears).

It is important to note that targeting specific budget balances rather than underlying expenditure increases (net of tax measures) has tended to result in poor budgetary practice in Ireland of late. Targeting deficits rather than net spending levels has allowed repeated slippages in spending to be masked by gains from increased cyclical revenues, higher-than-expected corporation taxes, and lower interest costs in recent years. This has facilitated somewhat misleading claims of budget targets being met while many of these gains are likely to prove temporary.

Box A: Surplus Aversion in a Recovered Economy

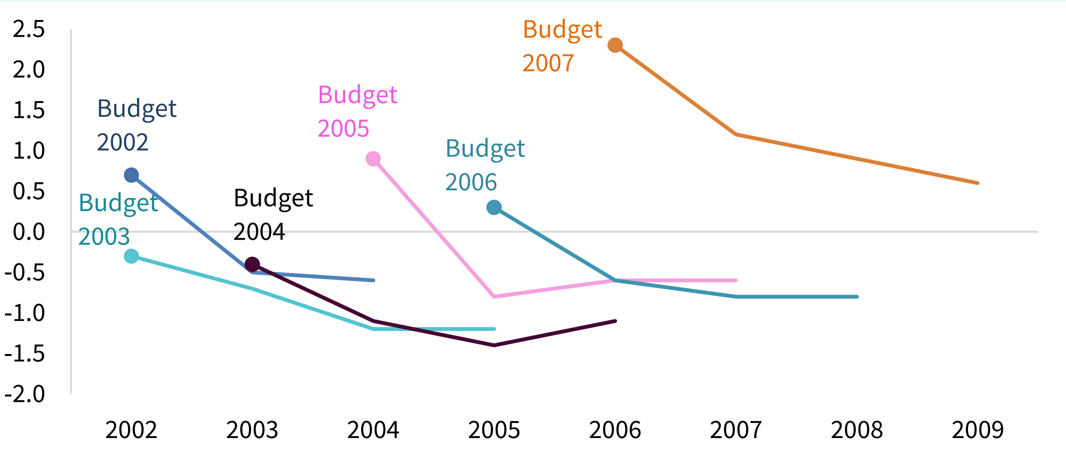
This Box examines how Irish governments have tended to show an aversion to targeting surpluses. This has proven to be the case even when the economy is faring very well.

A common feature in budgetary policy internationally has been the presence of "deficit bias": a tendency for governments to run deficits more often than not, hence accumulating debt and risking fiscal crises. Taking the 1,281 of annual observations available for OECD countries over 1960–2018, we can see that countries spent 73 per cent of these years in deficit.[6] Of course, deficits might be perfectly sustainable if growth, interest rates and existing debt ratios are favourable.

The flipside of deficit bias is that governments will often show an aversion to running surpluses. This can be for a number of reasons. It can be due to weak management of the public finances or distorted political incentives that favour more spending and less tax.[7] But an aversion to surpluses can also be due to perceptions that surpluses imply a government is not using all of the available resources at its disposal to tackle various policy challenges. This perception is a flawed one, given that resources would often only be accumulated temporarily when the economy is benefitting from good times and temporary tax surges. These surpluses can then give more scope for providing support to the economy through higher government spending in bad times.

Figure A1: Surpluses in the 2000s were rarely planned

% GDP, General Government Balance



Sources: Department of Finance (various Budgets).
Note: Dots show preliminary outturns for year during which each Budget is actually released. Other observations are estimates for the year the budget is referring to and the forecasts for subsequent years.

The aversion to surpluses was evident in Ireland through the 2000s. As the economy boomed, with nominal GDP growth averaging 8.4 per cent per annum over 2002–2007 in Ireland, government plans of the day were that deficits would be run in the year the budget was set for, with deficits projected for the following two years as well (Figure A1). In Budgets 2005 and

[6] Based on data for general government net lending as a percentage of GDP in the OECD Economic Outlook No 105 - May 2019 dataset (partial coverage of 33 OECD countries over 1960–2018).

[7] There are several common reasons cited in economic theory for why governments tend to be biased towards deficits. "Short-termism": a tendency to pay insufficient attention to medium- and long-term budgetary considerations. "Common pool" problems: tendencies for constituencies to disregard the overall budgetary impact when seeking additional resources. And "time inconsistency" problems: difficulties sticking to plans, which can damage credibility.

2006, expected surpluses in the preceding year became deficits in the year being budgeted for. This is not to say that surpluses did not subsequently materialise. They did. But the surpluses were thanks in large part to surges in taxes from the property sector and an overheating economy. Both factors would prove temporary.

Following an appropriate growth rate for net policy spending would have seen larger surpluses result in the 2000s and these would have allowed more scope for government support in the subsequent downturn. Scope for this support to be provided is preferable to having to cut spending and raise taxes to shore up public finances and to prevent debt rising in bad times. Otherwise, policymakers risk (1) reinforcing a downturn by having to tighten up the public finances at the same time, thus contracting economic activity further and (2) impairing the government's capacity to borrow from markets to finance deficits at affordable interest rates.

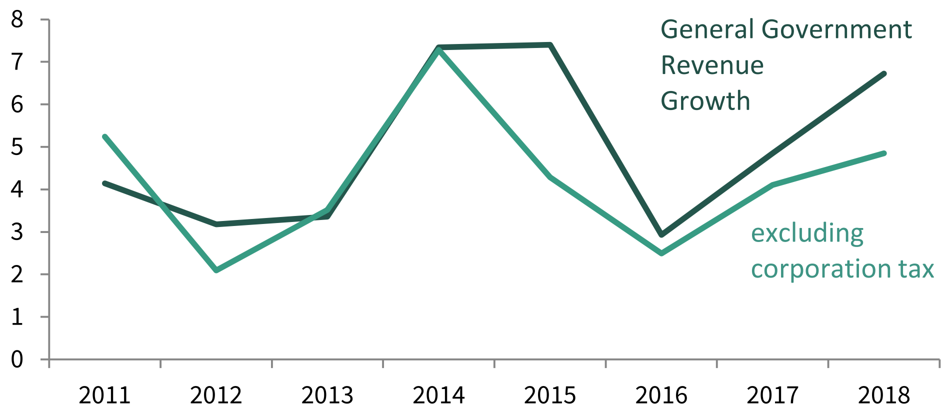
Fast forward to 2018 and we can see that there are some echoes of excessive increases in net policy spending preventing the appropriate surplus being run now. Although the economy has been performing strongly in recent years, the government has only just attained a surplus last year (a surplus of just €45 million in the context of annual spending of €82,000 million). Indeed, the Council has noted repeated slippages in spending that have led to a smaller surplus compared to what otherwise would have been achieved.

Revenue Growth

Revenue growth in recent years has been rapid (Figure 8). This owes much to the cyclical recovery, which has boosted taxes as the economy closes on its potential, and to surges in corporation tax in 2015 and 2018.

Figure 8: Revenue Growth has Averaged 5.8 per cent since 2014

% change year-on-year, general government basis



Sources: Department of Finance; and Fiscal Council workings.
Note: One-offs are excluded from general government revenue.

Excluding corporation tax, which has surged in recent years, revenue growth has averaged 4.6 per cent per annum over 2015–2018. Of the €10.4 billion corporation tax receipts received by the Government in 2018, the annual gain from excess growth in corporation tax receipts is estimated by the Council to be at the order of €3–6 billion for 2018 (Box B of the Council's *June 2019 Fiscal Assessment Report*). In particular, this reflects two sharp surges that occurred in 2015 and in 2018. Corporation tax receipts reached a record share of Exchequer taxes in 2018 (18.7 per cent as compared to just 10.3 per cent in 2011). They are highly concentrated, unpredictable, volatile, and prone to rapid changes due to idiosyncratic (firm-specific) factors as well as due to risks from international tax changes (Box H of the *June 2019 Fiscal Assessment Report*).

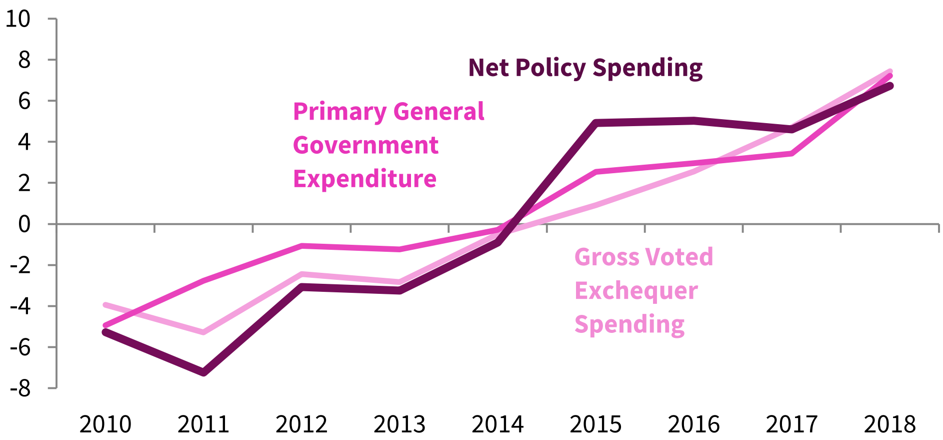
It is likely that corporation tax receipts will surpass forecasts yet again in 2019. June is a key month for receipts and has tended to be somewhat indicative of the performance for November (another key month). For the month of June, corporation tax receipts were ahead of forecast by €174 million (7.9 per cent). Any outperformance in corporation tax receipts for the year as a whole should not be used to mask spending increases that have not already been budgeted for.

Expenditure Growth

Expenditure growth has accelerated in recent years. Considering an appropriate measure of net policy spending (excluding one-offs, interest costs, and recognising the impact of tax measures), the pace of annual spending growth has risen from 4.9 per cent in 2015 to 6.7 per cent in 2018 (Figure 9). This compares to estimated nominal potential output growth of closer to 2½–4 per cent over this period (given potential output growth estimates of 2½ to 3½ per cent and weak price inflation). This indicates that the pace of policy spending growth has exceeded sustainable growth rates for both the economy and government revenues since 2015.

Figure 9: Expenditure Growth has Accelerated in Recent Years

% change year-on-year



Sources: CSO; Department of Finance; and Fiscal Council workings.
Note: Net policy spending is a measure of spending net of tax measures (in nominal terms). It is outlined in Box A of the November 2018 Fiscal Assessment Report (Fiscal Council, 2018c).

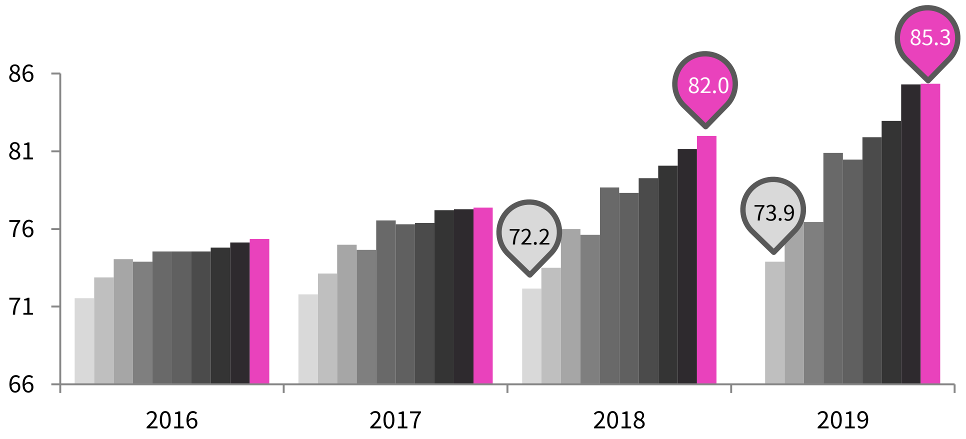
Spending Drift

With the public finances still in a vulnerable position, the Government has allowed a pattern of spending drift to emerge in recent years. Figure 10 compares spending plans relative to actual outcomes. Taking just 2018 as an example, the original forecast level of total general government expenditure was €72.2 billion (*Budget 2015*). The eventual outturn for spending in 2018 was €82 billion. This means that annual expenditure as of 2018 was almost €10 billion higher than originally projected. Part of this is due to revisions at budget time and unrealistic projections, but part of it is due to revisions outside of the usual budgetary process.

Within-year spending increases—changes over and above what was originally set out in the budget for that year—have added a cumulative €3.5 billion to annual expenditure increases since 2015 (Figure 11). These within-year spending increases imply a looser fiscal stance, a weaker-than-planned underlying budgetary position (abstracting from temporary gains) and they contribute to further overheating pressures.[8]

Figure 10: Spending Drift Over 2016–2019

€ billion, general government expenditure over different forecast vintages

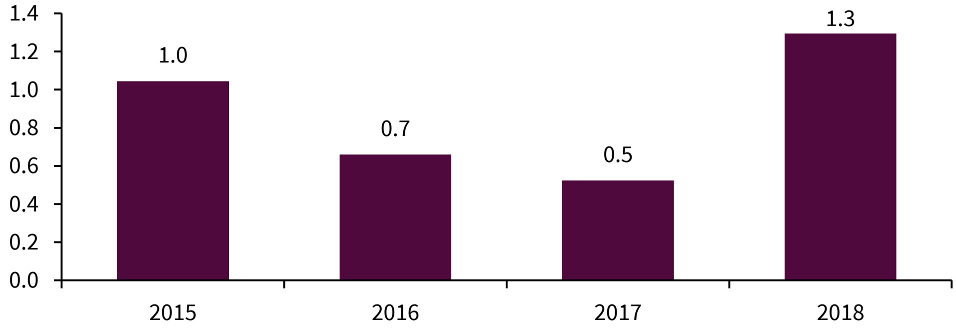


Sources: CSO; Department of Finance; and Fiscal Council workings.
Note: Lighter grey bars indicate older forecasts; red bars indicate current estimates. Note that forecasts of expenditure produced prior to *Budget 2017* were not on a so-called “ex-post” basis. This means that the Department did not include expenditure increases that would have been allowable under the fiscal rules as part of their initial forecasts. Therefore, the extent of spending drift relative to more realistic plans is overestimated.

[8] Box G of the *June 2019 Fiscal Assessment Report* noted that revenue in 2018 was almost €6 billion higher than anticipated in *Budget 2015*. Almost €5 billion of this was due to corporation tax receipts outperforming expectations.

Figure 11: Within-Year Spending Increases in Recent Years

€ billions



Sources: Department of Finance; and Fiscal Council workings.
Note: Within-year spending increases are based on gross voted spending outturns as compared to budget day estimates (*Budget 2015* for 2015; *Budget 2016* for 2016; *Budget 2017* for 2017. *SPU 2018* estimates used for 2018 due to the reclassification of spending on water services into the Department of Housing, having previously been funded by a mix of local government, non-voted spending, and Irish Water borrowings).

Repeated slippages mean that the pace of growth in net policy spending has risen substantially in recent years. For example, Table 1 shows how net policy spending growth rates for 2016 rose over the course of the budgetary process from a preliminary growth rate of 1.6 per cent at the time of *SPU 2015* (April 2015) to a growth rate of 3.1 per cent by budget time (October 2015), with the final outturn showing a growth rate of 5 per cent.

This shows how planned net policy spending increases were reasonable (when assessed against the medium-term potential growth rate of the economy) as at the time of each Stability Programme Update. Yet, by the time of the Budget, slippages were already evident, while outturns were markedly less prudent in 2016 and 2018 compared to original plans. The average (2016–2018) starting point in SPU documents (which is supposed to set the budget parameters) was for a prudent 3 per cent expansion. This slipped to 4 per cent by budget time, while the eventual outturn of 5.5 per cent on average exceeded typical estimates of sustainable growth and inflation and is not in line with prudent economic and budgetary management.

Table 1: Net Policy Spending Growth Rates Have Routinely Been Revised Up for the Year Ahead

% change year-on-year, nominal net policy spending growth

	2016	2017	2018	Average (2016–2018)
SPU (April of preceding year)	1.6	3.8	3.7	3.0
Budget (October of preceding year)	3.1	4.2	4.3	3.9
Outturn (Latest)	5.0	4.6	6.7	5.5

Note: The table compares the year-ahead-forecasts for net policy spending against eventual outturns. Net policy spending is an adjusted measure of nominal spending growth that takes account of discretionary tax changes as well as underlying spending growth (Box A *November 2018 Fiscal Assessment Report*). For example, for 2016, the table shows estimates from *SPU 2015*, *Budget 2016*, and the latest outturn.

Health Overspends

Health spending has been a big contributor to the within-year spending increase observed in recent years. Repeated slippages in health owe much to the emergence of a "soft budget constraint" problem. That is, spending limits are frequently allowed to be breached. This creates future problems by reinforcing the belief that upward revisions to the ceiling are very likely to be facilitated, hence weakening spending controls within the year. The interaction between unrealistic forecasts and a subsequent relaxation of ceilings can put the public finances at risk.

As a first step, the Government needs to ramp up monitoring practices in health spending. To this end, the new "Health Oversight Group" chaired by the Department of Public Expenditure and Reform established by the Government to monitor health spending more closely is a welcome innovation. Yet data limitations mean that information monitored by the group is much weaker than it should be. At the time of writing, the latest publicly available detailed information on health spending was only available to March of this year (HSE, 2019). Health overruns tend to occur late in the year and more timely information is a necessary input to monitoring spending developments. Other data limitations are highlighted in Collins (2019), which notes that the HSE is unable to give reliable data on consultant numbers and contract types.[9]

As a second step, planning for health spending needs to be drastically improved. Connors (2018) highlights failures in management and planning practices that may have led to budget overruns. These failures include the fact that plans for staff needs are not completed, despite the fact that staff costs represent about half of all health expenditure.[10] More generally, the practice of treating spending forecasts for health as hard ceilings intended to generate efficiencies rather than as comprehensive assessments of spending needs recognising all demographic and inflationary pressures does not seem to be working.

Budgetary Outturns so far in 2019

Government revenues have performed well in 2019 to date. Total Exchequer and PRSI revenues were €678 million above forecasts (+1.5 per cent) by end-August 2019 (Table 2). Within this, Exchequer tax receipts are ahead of forecasts (+€230 million). Shortfalls in VAT receipts (–€144 million), stamps (–€115 million), and income tax (–€48 million) are more than offset by higher-than-expected corporation tax (+€314 million) and excise (+€113 million) receipts. The weak VAT result may reflect a slight softening in retail sales figures since May. Elsewhere, PRSI continues to perform ahead of expectations (+€248 million) this year.

In year-on-year terms, the main tax headings (including PRSI) have shown strong growth for the first eight months of 2019. Corporation tax receipts are 12.9 per cent (€563 million) higher than for the same period of 2018; VAT is up by 5.5 per cent;

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[9] Collins (2019) notes that the "definitive number of Consultants employed broken-out by contract type and salary is not available" from the HSE. They conclude that "it is imperative that a more informative dataset is compiled, maintained and made available on Consultant numbers, pay and the costs of this grade to the Exchequer going forward". Consultants comprise 17.5 per cent (€474 million) of the basic pay bill in acute hospitals. Growth in numbers of consultants employed by the HSE was twice as fast as total HSE employment (18% compared to 9%) over 2012–2017.

[10] Connors (2018) notes that the Health Service Executive is required to produce National Service Plans setting out the number and type of staff the HSE expects to recruit within its budget. Connors (2018) notes that, since 2013, the NSP has made no reference to the number of staff the HSE expect to recruit throughout the year and the associated cost of these staff. The HSE is also required to produce a Pay and Numbers Strategy every year with detailed information on the number of staff to be hired. However, these reports have tended to be submitted very late in the year. For example, a revised version of the document for 2016 was submitted in December 2016, which looked to significantly increase the end-2016 staffing number. This was done despite not having the resources to undertake such increases. In 2017 and 2018, submissions took place in November and August, respectively.

income tax up by 7.9 per cent; and PRSI receipts up by 9.7 per cent. An exception is stamp duties, which is roughly at the same level as it was by end-August 2018. Stamp duties have tended to be lumpy owing to their reliance on transactions so that this weakness could prove temporary. The Department has noted that receipts are concentrated in the final months of the year. Activity levels in commercial property investment have been high in recent years and may correct to lower levels meaning that this revenue source is worth monitoring closely (Box F, *November 2017 Fiscal Assessment Report*).

Table 2: Exchequer and PRSI Revenue to end-August 2019

€ million cumulative, unless stated

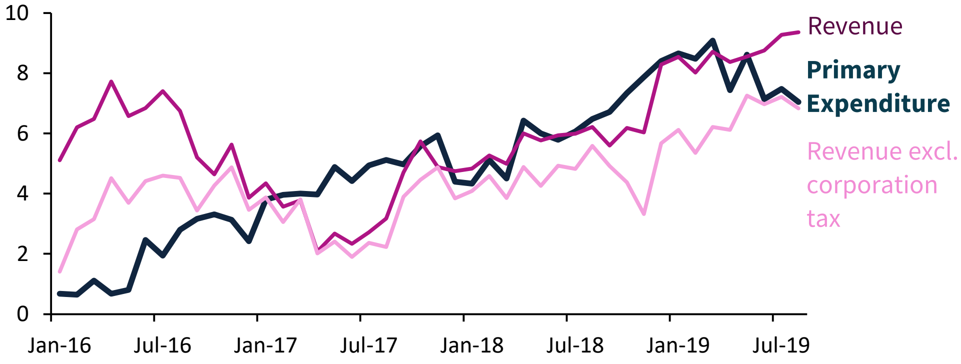
	Outturn	Forecast	Difference	Difference (%)
Exchequer Tax	35,050	34,817	233	0.7
Income Tax	14,080	14,128	-48	-0.3
VAT	9,901	10,045	-144	-1.4
Corporation Tax	4,928	4,614	314	6.8
Excise Duty	3,916	3,803	113	3.0
Other Taxes	2,224	2,227	-3	-0.1
PRSI Receipts	7,459	7,211	248	3.4
Other Revenue	3,250	3,050	200	6.6
TOTAL	45,757	45,079	678	1.5

Sources: Department of Finance Analytical Exchequer Statement; and Fiscal Council workings.
Note: Other taxes include stamps, capital taxes, motor tax and other unallocated tax receipts. Other revenue includes the National Training Fund, other A-in-As, non-tax revenue, and capital resources. PRSI and National Training Fund receipts include their excess over expenditure as indicated in the memo items of the Department's Analytical Exchequer Statement.

Comparing Exchequer and PRSI revenue with primary (non-interest) expenditure, the fast pace of revenue growth observed continues to be tracked closely by spending (primary spending growth exceeded revenue growth in much of 2018–2019). It is worth considering growth in revenues excluding the corporation tax receipts, given the extent to which recent surges in these receipts could prove temporary (Box B and H *June 2019 Fiscal Assessment Report*). If corporation tax receipts are excluded, the pace of primary expenditure growth can be seen to exceed revenue growth since early-2017 (Figure 12).

Figure 12: Exchequer and PRSI Revenue & Primary Expenditure

% change year-on-year (12-month moving sum, central government basis)



Sources: Department of Finance; Analytical Exchequer Statements, and Fiscal Council workings. Note: Transactions without general government impacts are excluded. Revenue is Exchequer tax and non-tax revenue plus appropriations in aid, excess capital resources and excess PRSI and National Training Fund receipts as indicated in the memo items of the Department's Analytical Exchequer Statement. Primary Expenditure is Gross Exchequer Expenditure minus national debt interest. Central Bank Surplus receipts are moved from April to May in 2016 for consistency.

Given the fast pace of growth in gross spending allowed for 2019 as a whole (5.7 per cent), it is not surprising to see that most spending areas are in line or below forecast spending for the year to date. Gross voted spending for the year so far is €262 million below forecast.

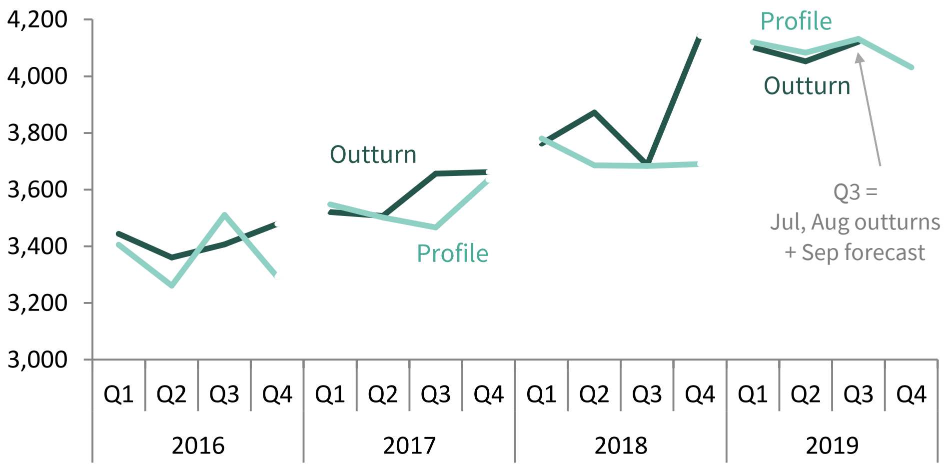
The pace of spending growth in 2019 compared to the same time last year has been fast. Gross voted spending is up 6.5 per cent compared to end-August 2018. Part of the reason that spending has remained in line with forecasts for the year to date, even though it is growing faster than planned for the year as a whole, is due to how the forecasts were set out. Generous forecast increases were set for the early part of the year whereas much tighter forecasts were set for the end of the 2019. For instance, the total gross voted spending increase allowed for the first three quarters of this year averaged 7.3 per cent year-on-year. By contrast, forecasts for the final quarter of 2019 only allow for a year-on-year increase of 1.7 per cent.

Health Spending in 2019

Despite being close to forecasts by end-August, gross voted spending in Health is rising quickly in year-on-year terms in 2019. Health spending would have to stay relatively flat for the remaining months of this year to remain on track. This seems unlikely. Recent years have seen spending in the last quarter of the year turn out to be higher than in previous quarters (Figure 13).[11] As it stands, gross current spending of €11 billion is €691 million (+6.7 per cent) higher than in the same period of 2018. For the full year, an increase of €901 million (+5.8 per cent) was budgeted for.

Figure 13: Health spending needs to stay relatively flat to avoid an overrun in 2019

€ millions, quarterly gross voted current health spending



Sources: Department of Finance; and internal Fiscal Council calculations.
Note: Health spending shown in gross voted current spending terms. The 2019 Q3 outturn reflects the outturn for the months of July–August, and the forecast for September.

It is possible that the forecast increases in Health spending for the first three quarters of 2019—which are relatively larger than what is allowed for the final quarter—will mean that health spending does not experience overruns until near the end of the year. It may even accumulate a relatively large underspend prior to then. But the risks of an overrun for the year as a whole will depend crucially on the

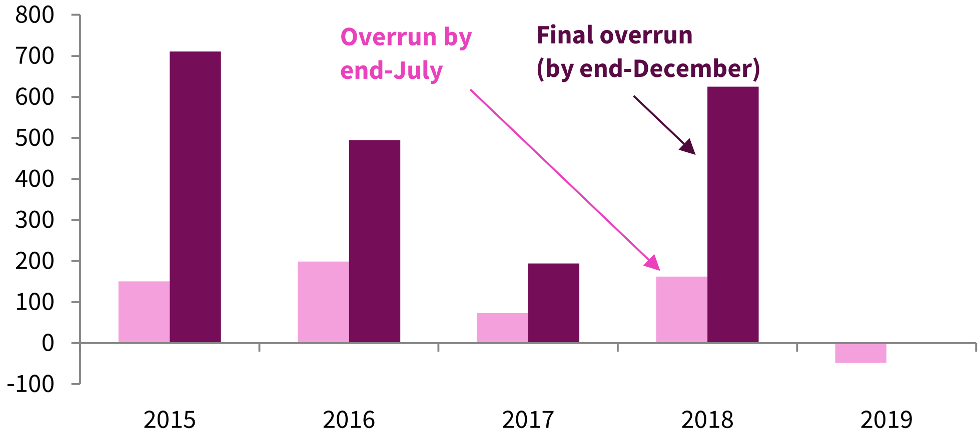
[11] Box D of the *November 2018 Fiscal Assessment Report* shows how Health overspends have tended to ramp up in the final quarter in recent years. Connors (2018) notes that in the final quarter of each of 2015, 2016 and 2017, the HSE employed an additional 1,432 staff on average (around 40 per cent of their annual increase). The fact that so much additional long-lasting spending takes place in the final quarter of the year can mean less time to adjust spending elsewhere within the same year and it can also trigger larger spending carryovers into the following year.

extent to which Health spending will achieve its forecast performance in the final months of the year, which seems overly optimistic.

Health spending has experienced repeated overruns in recent years (current spending overruns average €0.5 billion over 2013–2018) and the recent track record has been for growth in health spending to ramp up in the latter part of the year (Figure 14).

Figure 14: Health overruns tend to mainly arise late in the year

€ million, gross voted health current expenditure overruns



Sources: Department of Finance Fiscal Monitors; and Fiscal Council workings.

The *Mid-Year Expenditure Report 2019* (Department of Public Expenditure and Reform, 2019, p.3) also signals risks of another overrun this year, noting that:

> *"In 2017, 49 per cent of the additional year-on-year provision for day-to-day expenditure had been accounted for by the end of June. Despite this, a Supplementary Estimate of over €190 million was required for the year. This demonstrates the tendency for Health spending to be higher in the second half of the year. This trend is particularly evident in Quarter 4 and has been observed in the last two years. In light of this trend, it is concerning that only 2 per cent of the additional €0.9 billion allocated to day to day health expenditure this year has been allocated to the final three months of 2019. Indeed, the Department are only projecting that Quarter 4 expenditure in 2019 will be €18 million higher than same quarter in 2018, an optimistic position given the trend in the year to date."*

Given the concerns raised by the Department, the strong growth rates thus far, and the optimistic assumption that spending will remain relatively flat for the rest of the year, there is a strong risk of an overrun occurring again in Health.

Compliance with Fiscal Rules

The fast pace of spending growth goes against the principle of the fiscal rules, which tries to ensure that spending growth is sustainable over the medium to long run. In principle, the spending rule (the Expenditure Benchmark), which the Government should adhere to, limits growth in net non-interest spending to the pace that the economy can grow at sustainably. In practice, the rules have been a weak constraint in good times and overly tight in bad times, given how they are applied (Barnes and Casey, 2019).

The Council has adopted a new "principles-based approach" for assessing the fiscal rules (Fiscal Council, 2019b). The European Commission assesses EU fiscal rules based on their own operational approach and based on estimates of the cycle, which rely on an EU-wide Commonly Agreed Methodology (CAM) that have tended to produce implausible results for Ireland. The Council has therefore adopted a new principles-based approach that makes the assessment simpler and more robust. The approach avails of the Department of Finance's alternative measures of the cycle.

On the basis of the Council's principles-based approach, the government's target ("Medium-Term Objective") of a structural deficit that is not larger than 0.5 per cent of GDP was met in 2018. The structural balance was estimated to be +0.2 per cent of GDP on this basis. However, surges in corporation tax receipts play a large role in achieving this, and there was a significant deterioration in the structural balance in 2018.[12] A second pillar of the rules looks at spending growth (the Expenditure Benchmark). Government spending breached the Expenditure Benchmark limit in 2018 on the basis of the principles-based approach. While net spending is forecast in *SPU 2019* to grow below the limit for 2019, this is at risk, given the Council's expectations that general government expenditure figures for 2019 will be revised up and the possibility of large spending overruns occurring again.

[12] Achievement of the MTO should be assessed taking into account revenue windfalls. If overachievement of the MTO were due to revenue windfalls, the Expenditure Benchmark would still apply. The Council assess that corporation tax receipts do not qualify as "windfall" revenues under the standard definition outlined in the Vade Mecum (European Commission, 2019). Yet considerable concerns remain about the long-run sustainability of these receipts.

4. The Fiscal Stance for *Budget 2020*

In this section, the Council assesses the prudence of the overall fiscal stance for *Budget 2020*. It is informed by (1) a broad economic assessment that considers appropriate management of the cycle as well as the sustainability of the public finances; and (2) an assessment of compliance with the legislated domestic and EU fiscal rules.

In the absence of an external shock, economic growth would be likely to remain strong, even if moderating somewhat. The debt ratio would continue to fall at a steady pace. The headline primary balance would remain broadly unchanged and interest costs should be relatively insulated from changing monetary conditions.

However, there is an unusually high risk that actual outcomes will be much different. This particularly depends on how Brexit proceeds, but also on how wider economic conditions pan out in what is an uncertain period for the global economy (Section 2). Adverse macroeconomic developments would be expected to reduce revenues and increase unemployment spending.

As an illustration of the macroeconomic risks and their impact on the public finances, we can consider the Department's updated estimates, as published in the *Summer Economic Statement 2019*, for a disorderly Brexit alongside the estimates produced by the Council and the ESRI. The Department estimates that a disorderly Brexit scenario would lead to a deterioration in the general government balance by 0.9 to 1.9 percentage points of GDP in 2020. The Council's estimates, based on shocks taken from the Central Bank and ESRI fed through the Council's own models, suggest that the impact would be at the upper end of this range (1.7 percentage points taking the ESRI's scenario) or even higher (3.2 percentage points taking the Central Bank's scenario).

The Department expects that the path for the budget balance in a disorderly Brexit scenario would be such that a balanced budget might not be achieved again until 2023 (Table 3). There is substantial uncertainty around these estimates. The deficit impact might be more severe in a disorderly Brexit scenario. In particular, it is likely that sectoral supports will be introduced by the Government making the deficit impact larger than is estimated here. In terms of the impact on the debt ratio, the

Council assesses that such an impact would cause the debt-to-GNI* ratio to stagnate at high levels over the next few years or even to rise.

Table 3: Estimated disorderly Brexit impacts on budget balance

Percentage points of GDP (relative to official Government forecasts in *SPU 2019*)

Scenario	Deficit Impact (p.p.)	Timing
ESRI	0.9	Long-run impact
Fiscal Council (using ESRI's shock as an input)	1.7	Impact in 2020
Fiscal Council (using Central Bank's shock as an input)	3.2	Impact in 2020
Department of Finance (*SES 2019*)	0.9 to 1.9	Impact in 2020

Expected Path for General Government Balance					
	2019	2020	2021	2022	2023
Official Forecast*	0.2	0.4	0.6	0.8	1.0
Disorderly Brexit Scenario	-	-½ to -1½	-½ to -1	-¼ to –¾	-¼ to ¼

Sources: Fiscal Council workings based on CBI and ESRI/DoF.
Notes: Official forecasts for 2019 are taken as *SPU 2019* estimates. The forecasts for 2020 onwards are from the *Summer Economic Statement 2019*, which incorporate a faster spending growth assumption for the medium term than *SPU 2019*. Details of the shocks outlined are set out in *SES 2019* and in Box C of the *June 2019 Fiscal Assessment Report*.

Budgetary outturns are also at risk of spending overruns, particularly in health and on major capital projects. Further ahead, the concentration of corporation tax receipts, costs associated with Ireland's expected failure to meet its climate change and renewable energy targets, and additional spending pressures could lead to worse-than-expected budgetary outcomes. These risks mean it is quite likely that forecast budget surpluses will not materialise unless these are temporarily boosted by gains in terms of lower interest costs, higher corporation tax receipts, or revenues associated with a further cyclical upswing.

The level of spending in 2019 is expected to be revised upwards

A number of factors suggest that the Government risks a further drift in spending relative to its initial plans for 2019 as has happened in recent years.

1. Health spending forecasts look unrealistic for the second half of the year (Section 3). The average annual overrun in current spending for Health in recent years has been €0.5 billion (0.2 per cent of GNI*).

2. Social payments for 2019 appear to have been underestimated by the Department of Finance. This is due to the fact that the forecast level of social payments for 2019 was not revised up in either *SPU 2019* or the *Summer Economic Statement 2019* to account for a higher-than-expected outturn in 2018 (meaning a higher base level of spending was not accounted for). *Budget 2019* had an increase of €0.5 billion in social payments in 2019 but—following the publication of the 2018 outturns by the CSO—April's *SPU 2019* forecast for social payments in 2019 was not revised up proportionately to reflect the higher-than-expected outturn in 2018. This position was further not reflected in the figures included with the *Summer Economic Statement 2019* and the CSO restated the higher 2018 position in their July update of the Government Finance Statistics. This could mean an upward revision of €0.5 billion (0.2 per cent of GNI*) to general government spending for 2019 relative to *SPU 2019* estimates, hence weakening the general government balance to the same extent.[13]

3. Although the government have stated that it is their intention to pay a Christmas Bonus to weekly social welfare recipients this year, it is still not provided for in 2019 spending forecasts. If paid in full, as was done last year, this would add €0.3 billion (0.1 per cent of GNI*) to spending for 2019.

If all of these spending revisions and overruns were to materialise, it would mean a general government expenditure figure in 2019 of up to €1.3 billion (0.6 per cent of GNI*) over and above what was forecast.

[13] This is not expected to impact on cash or gross voted expenditure (it was provided for on that basis). But it does mean that the broader general government measure of spending was underestimated. This is a key measure, which captures more of government spending and is central to assessments of the fiscal rules.

It might be that another overperformance in corporation tax receipts and lower-than-expected interest costs accommodates overruns in spending, including in health, in budget balance terms as in recent years. But this would mask the fact that the underlying budgetary position would have deteriorated (the overall budget balance would be as forecast owing to unexpected—and possibly temporary—gains masking spending increases).

Plans for budgetary measures in 2020

The June *Summer Economic Statement 2019* set out plans for a €2.8 billion package of measures for 2020. This comprised commitments of €1.9 billion, €0.2 billion for additional costs associated with the National Broadband Plan and National Children's Hospital and €0.7 billion to be allocated as part of the Budget.

As well as the possibility of overruns in 2019, there are two aspects of the budgetary plans for 2020 that appear different relative to April's *SPU 2019* plans. However, it is not clear from recent publications, and the Department of Finance should provide more clarity on policy decisions embedded in any changes to budgetary forecasts.

1. On the face of it, the *Summer Economic Statement 2019* contains tax cuts for 2020 that are €300 million larger than had been outlined in April's SPU 2019. The Council queried this apparent difference with the Department of Finance, which maintained that the difference was only presentational, though it was not able to provide any reconciliation between the two sets of figures.

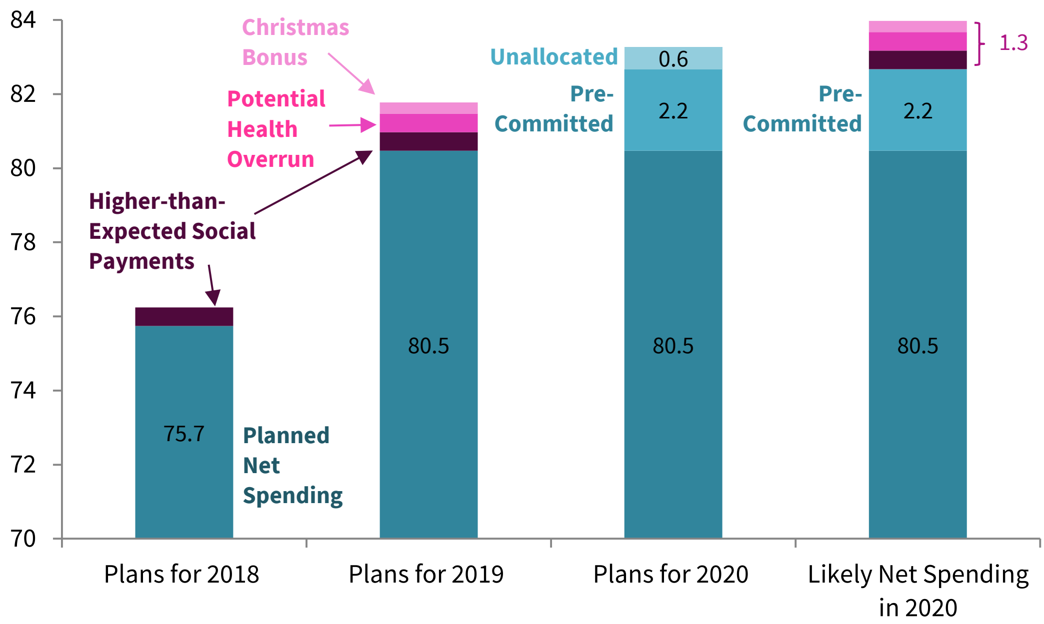
2. In the Summer Economic Statement, the Government set aside up to €0.2 billion in 2020 to accommodate additional funding needs for the National Broadband Plan and National Children's Hospital in 2020, both of which were subject to large overruns (Box F, *June 2019 Fiscal Assessment Report*). All else equal, this would mean additional pre-commitments of €0.2 billion for 2020. The Department has also confirmed that spending plans are to be amended so that no other project will be affected. It has noted that this implies total capital investment spending will increase by €0.2bn in 2021 and 2022 and €0.3bn for 2023 and 2024. It is expected that the additional amounts will be taken out of previously unallocated resources included in

forecast spending levels for each of the forecast years. For instance, unallocated resources for 2020 were €0.3 billion at the time of *SPU 2019*.

Taking the possible within-year general government spending revisions and their impact on spending levels in 2020, an extra €1.3 billion of expenditure could be likely compared to what was planned just four months ago (Figure 15). These slippages would repeat the pattern of within-year increases observed in recent years and would be inappropriate. They would imply a looser fiscal stance and contribute to further overheating pressures. They also reduce the scope for budgetary policy to support the economy further in the event of an adverse shock materialising in the near future.

Figure 15: Slippages may exceed planned spending increases

€ billions, general government net policy spending levels



Sources: CSO; Department of Finance; and Fiscal Council workings.

Setting a prudent *Budget 2020*

In its *June 2019 Fiscal Assessment Report*, the Council assessed that the Government should stick to its planned net spending increases for 2020 of €2.8 billion. This was based on the view that (1) it was consistent with existing plans (as in *SPU 2019*); (2) it was slightly below the sustainable pace of spending increase indicated by the economy's potential growth; (3) it would allow for some additional scope to cushion some of the effects of a disorderly Brexit if it occurred; and (4) it would offset some of the fast spending increases in previous years.

Table 4: Identifying the Appropriate Gross Fiscal Space

Estimates of Average Potential Output Growth 2020–2023 (%)	
Fiscal Council	3.0
ESRI	3.3
DoF (GDP-Based Alternative)	2.2
Forecasts of Inflation for 2020 (%)	
GDP Deflator	1.7
Core HICP	1.5
HICP	1.1
Reference Rate (%)	
Potential Growth Rate + Inflation	c.4½
Gross Fiscal Space - Expenditure Benchmark Basis (€bn)	
Total General Government Expenditure in 2019	85.3
Less Interest Expenditure	-4.7
Less EU co-financed current spending	-0.5
Less Public Gross Fixed Capital Formation	-7.7
Plus four-year average of Public GFCF	6.2
Less Cyclical Unemployment Expenditure	0.0
Less One-Off Expenditure Items	0.0
Corrected Expenditure Aggregate	78.6
Corrected Expenditure Aggregate × Reference Rate of 4½ %	3.5

Sources: ESRI (McQuinn *et al.*, 2017); Department of Finance (*SPU 2019*); and Fiscal Council workings. Note that the Council's estimates of potential are based on its own models of potential output (Casey, 2019) and the Department's forecasts. While the *June 2019 Fiscal Assessment Report* based estimates on forecast underlying domestic demand growth, these estimates use forecasts for GNP so as to incorporate the expected performance of net exports.

The Council assesses sustainable growth in net policy spending on the basis of estimates of potential output over the medium-term and inflation. Table 4 sets out how net policy spending would increase if it were to expand in line with the economy's sustainable medium-term growth rate. Using the Council's models of potential output, growth rates over the medium term average 3 per cent, while the Department's forecasts of inflation for 2020 are 1.1 per cent and 1.5 per cent on a HICP and Core HICP basis, respectively, and 1.7 per cent on the basis of the GDP deflator. Taken together, the estimates suggest a sustainable nominal growth rate of around 4½ per cent. When this is applied to a measure of underlying spending under the government's discretion (the "Corrected Expenditure Aggregate"), it suggests an envelope for increased budgetary measures of €3½ billion for 2020.

However, in its June 2019 Fiscal Assessment Report, the Council assessed that the Government should be cautious with its budget for 2020. This reflects the risks associated with a hard Brexit, the reliance on corporation tax, possibilities of overheating, and the rapid rise in spending between 2017 and 2019. Being cautious and sticking to the plans set out in *SPU 2019* for an increase of €2.8 billion rather than the €3½ billion would also help to limit the possibility of rising debt ratios, loss of creditworthiness, and a need for sizeable correction in the public finances. In particular, it would allow more room for further support to be provided in the event of an adverse shock materialising without raising concerns of fiscal sustainability, and would allow fiscal policy to cushion some of its effects.

The Council also noted that a smaller expansion than the €2.8 billion currently implied by *SPU 2019* plans would be desirable. Again, this recognises the severe risks posed by Brexit, the reliance on corporation tax receipts, and the risks of further overheating. It noted that this could include not using the €0.6 billion that was set aside for assumed tax cuts and unallocated spending increases.

Initial plans were for a €2.8 billion increase in *Budget 2020*

Sticking to the *SPU 2019* plans, as the Council advises, entails some €2.8 billion of budgetary increases for 2020 over the planned level for 2019 (Table 5). This is on the basis of the general government data underpinning the *SPU 2019* forecasts and based on the net spending change implied by those forecasts (using the same approach as is used to assess the Expenditure Benchmark).

Sticking to the *SPU 2019* plans means that—if 2019 spending plans were delivered—there would only be scope for €600 million of general government measures to be formally announced on budget day. This reflects the fact that some €2.2 billion of the total €2.8 billion package of measures implied is already pre-committed on the basis of the *SPU 2019* plans. Based on the provisional *SPU 2019* plans, this €600 million comprised €300 million of unallocated spending, which could then be allocated on budget day, plus a net sum of €300 million provisionally set aside for tax-reducing measures (Table 6). If further discretionary measures to increase tax or spending were to be introduced beyond the *SPU 2019* plans, then the Council assesses that the Government should introduce additional revenue-raising measures to preserve overall sustainability or it should scale back planned spending increases and tax cuts elsewhere.

Table 5: Initial plans were for a €2.8 billion budget increase

€ million, (general government basis)

	2017	2018	2019	2020
Planned net spending increase (*SPU 2019)*				
Total Expenditure	77,363	81,983	85,345	87,600
Less Interest	5,803	5,231	4,760	4,325
Less EU co-financed current spending	500	470	500	540
Less Public Investment	5,360	6,524	7,740	8,040
Plus four-year average of Public Investment	4,909	5,470	6,224	6,916
Less Cyclical Unemployment Expenditure	65	65	-46	-114
Less One-Off Expenditure Items	178	213	0	0
Corrected Expenditure Aggregate (CEA)	70,366	74,950	78,616	81,725
Discretionary Revenue Measures (DRMs)	852	852	958	296
Corrected Expenditure Aggregate less DRMs (CEA*)	69,515	74,099	77,658	81,429
Planned Net Spending Increase ($CEA^{*}_{t} – CEA_{t-1}$)				2,813
Total planned budgetary increase				2,813

Sources: *SPU 2019;* CSO; and Fiscal Council workings.
Notes: General government data are as at the time of *SPU 2019.* Cyclical unemployment expenditure is based on an assumed constant NAWRU of 5½ per cent. Discretionary revenue measures include provisionally planned tax cuts and revenue raised by not indexing the tax system.

In cash terms, the plans entailed a €2.4 billion increase in 2020

On a cash basis, the Government's plans at the time of the *SPU 2019* amounted to cash tax and spending changes of about €2.4 billion over the planned 2019 level (Table 6). This comprised an increase in gross voted and non-voted spending of €2.1 billion and provisional plans for net tax cuts of €0.3 billion.

About €1.8 billion of the cash spending increase was pre-committed (in other words, already allocated). The €1.8 billion was made up of carryover costs from previous budget decisions (€0.3 billion); public sector pay increases (€0.4 billion); demographic-related costs (€0.5 billion); and capital spending increases (€0.7

billion). Previous tax measures, introduced in *Budget 2019*, had a marginal carryover cost into 2020 (€25 million).

This meant that—in sticking to *SPU 2019* plans—there would be €0.6 billion of resources available to be allocated on the day of the budget (split evenly between the unallocated spending and provisionally planned tax cuts).

Table 6: Pre-Commitments and Provisional Cash Plans for 2020

€ billion, (cash basis)

	As of SPU 2019 (April 2019)	As of SES 2019 (June 2019)
Total cash measures planned	2.4	2.7
Gross voted + non-voted spending increases	2.1	2.1
Provisionally planned tax cuts	0.3	0.6*
Amounts pre-committed	1.8	2.0
Carryover cost of previous spending measures	0.3	0.3
Public sector pay increases	0.4	0.4
Increased costs due to demographic changes	0.5	0.5
Capital spending increases	0.7	0.7
Additional spending on NCH + NBP		0.2
Carryover cost of previous tax measures	0.0	0.0
Amounts not yet committed	0.6	0.7
Unallocated spending	0.3	0.1
Provisionally planned tax cuts	0.3	0.6*

Notes: NCH + NBP refer to the National Broadband Plan and National Children's Hospital.
* The Department has noted that the €0.6 billion of tax cuts set out in *SES 2019* is only different to the €0.3 billion set out in *SPU 2019* due to differences in how the figures are presented.

However, the *Summer Economic Statement 2019* incorporates tax cuts for 2020 that appear larger than planned at SPU time and an "expenditure reserve" to cover costs associated with the National Broadband Plan and National Children's Hospital. The Department has not provided sufficient information with the *Summer Economic Statement 2019* to assess these plans correctly. Yet, as far as the Council can ascertain, it implies that (1) unallocated spending has been reduced to €0.1 billion from €0.3 billion due to the allocation of €0.2 billion to costs associated with the Broadband plan and Children's Hospital; and (2) provisionally planned tax cuts may be €0.3 billion higher than indicated at the time of *SPU 2019*. The Department has noted that the difference in tax cuts is only presentational, though it was not able to provide any reconciliation between the two sets of figures. Taking the €0.6 billion of tax cuts set out in *Summer Economic Statement 2019* , plus the €0.1 billion of remaining unallocated spending, the Government notes that this "leaves €0.7 billion to be specifically allocated as part of the Budget" (*Summer Economic Statement 2019*, p.ii).

If a larger total budgetary increase for 2020 than originally outlined is now planned, then this should be offset by revenue-raising measures or savings elsewhere.

Within-year spending increases in 2019 will impact 2020 plans

The Council's view that an increase of €2.8 billion for 2020 would be prudent was predicated on the Government sticking to its plans for 2019 as set out in *SPU 2019*. However, additional within-year increases now look very likely.

The high probability of further within-year spending increases occurring again in 2019 raises some issues. If the Government sets out planned increases in net spending of €2.8 billion for 2020 but goes beyond plans for 2019 yet again, this will mean a much higher level of spending in 2020. It is the Council's assessment that the total impact of discretionary budgetary measures introduced should still be consistent with the Government's original spending objectives for 2020, as set out in *SPU 2019*, regardless of whether these occur in late 2019 or across 2020.

The Government needs to avoid further slippages from occurring again in 2019. This means that "supplementaries" (additional spending allocations to Departments for the current year) should be avoided or overruns offset with savings in other areas.

If spending overshoots occur in 2019, this would reduce or eliminate the space for any new measures on Budget day and the government could need to scale back pre-commitments for 2020 to achieve this objective.[14] This means that "unallocated resources" for 2020 would have to be reduced by the equivalent size of any overruns

[14]The Minister acknowledges the need for this somewhat in the *Mid-Year Expenditure Report 2019* (p.i) noting that any health spending overruns in 2019 "would severely impact on the scope for Budget 2020."

that occur in 2019 and some pre-existing commitments may have to be adjusted to take account of these overruns.

For 2020, the Government should introduce offsetting budgetary measures elsewhere if it intends to go beyond its *SPU 2019* plans. This includes through additional revenue-raising measures or through other expenditure savings. Indeed, the Minister notes in the *Mid-Year Expenditure Report 2019* that any additional spending or tax cuts beyond the planned €2.8 billion would be funded by offsetting revenue-raising measures.

Dealing with Brexit-Related Costs

Brexit, in any form, will inevitably mean substantial costs for the public finances. This will include potential costs associated with customs infrastructure, costs associated with higher unemployment and lower tax receipts, and possible sectoral supports. The implications of these costs for the underlying budgetary position will depend on how long lasting they are. For instance, some costs (such as for customs infrastructure) will largely be once off in nature. Hence, they may not be as relevant for assessments of the fiscal rules or for the path of underlying spending. Other costs (such as additional customs staff) could be more likely to recur in subsequent years. It will inevitably take time to assess the precise fiscal consequences of any Brexit-related outcome. Yet this distinction, between temporary costs associated with Brexit and new longer term costs, is an important one for assessments of the sustainability of the public finances.

Ignoring additional costs associated with any Brexit outcome—beyond what is currently planned—the Council assesses that the Government should stick to its original plans for spending in 2020 as set out in *SPU 2019*. This means that it should deliver on its spending plans for 2019 and on the stated net spending increase for 2020 of €2.8 billion. If the Government goes beyond its original net spending plans for 2019 and 2020—due to reasons other than unavoidable Brexit-related costs or measures that are clearly temporary in nature—then it should scale back pre-commitments or introduce offsetting measures elsewhere.

High levels of government debt and faster-than-planned spending increases in recent years have left the public finances unnecessarily vulnerable and a disorderly Brexit could have severe consequences. The pattern of spending slippages in recent years means that the Government has relatively less scope to introduce measures that would support the economy than it otherwise would have in the event of a disorderly Brexit. Box C of the *June 2019 Fiscal Assessment Report* showed how—if *SPU 2019* plans were followed—a soft Brexit scenario could allow the automatic stabilisers operate with only a small rise in the debt ratio and limited need for active policy measures to stabilise the debt path. That is to say that the Government could let unemployment-related costs rise and taxes fall without expecting an indefinite rise in debt ratios. However, a disorderly Brexit could spell much more severe consequences. Trade-offs in this scenario would be much more challenging. Given the starting position—of a high debt burden—the Government might need to cut spending or raise taxes to prevent debt ratios from rising. Long-term levels of output would be worse in any such scenario rather than simply being an issue of temporary disorder in the economy. Should a more adverse shock materialise, the policy response would need to be carefully assessed. However, the Government should in principle act to support the economy in so far as possible during any period of unusually weak demand.

Developing credible medium-term budget plans

For 2021–2024, the Government needs to develop a credible medium-term strategy. The Government's medium-term spending projections are based on technical assumptions that are unlikely to reflect actual policy decisions, while medium-term targets, including for debt ratios, need further development.

Since the Council's *June 2019 Fiscal Assessment Report* was published, the Department has published an alternative medium-term assumption to allow for 3¼ per cent year-on-year current spending growth from 2021 onwards. This assumption, set out in the *Summer Economic Statement 2019,* compares to the technical assumption outlined in the April *SPU 2019* for growth of 2½ per cent per annum. The updated assumption moves in the direction of providing more plausible spending forecasts. A lower general government surplus of 1.2 per cent of GDP is the result, as compared to 1.6 per cent under the previous technical assumption. However, it still amounts to another arbitrary technical assumption. This reduces the credibility of the medium-term spending forecasts and it means that it is still unlikely that spending forecasts reflect intended future policies and outcomes.

As noted in the Council's *June 2019 Fiscal Assessment Report*, a better approach to budgetary planning could be built around four elements:

- First, it should start with a clear statement of the sustainable growth rate that net policy spending can grow at.

- Second, multi-year departmental expenditure ceilings should be framed in the context of this upper limit and more realistic forecasts for spending should be developed.

- Third, the debt ratio target should be restated as a percentage of modified GNI* with a clear timeframe; it should be clarified whether it is a steady-state target or a ceiling; it should have clear staging posts; and it should be lower to reflect Ireland's volatile growth rates.

- Fourth, the Government needs to reduce its reliance on corporation tax receipts, which has built up in recent years. One option (Box B, *June 2019 Fiscal Assessment Report*) would be to notionally set aside corporation tax receipts above forecast levels through in-year allocations to a "Prudence Account". Allocations could be based on the excess between actual and forecast corporation tax receipts. At year end, these notional amounts could then be turned over to the rainy-day fund (the "National Surplus (Exceptional Contingencies) Reserve Fund") or used to reduce debt.

Since the Council's *June 2019 Fiscal Assessment Report* was published, the Minister has noted in the *Mid-Year Expenditure Report 2019* that it is:

> *"important that budgetary policy is tailored to what is right for the economy rather than on the basis of one-size-fits-all rules that do not account for the unusual features of the Irish economy (such as the limited information content of traditional economic variables such as GDP). Options include formulating the debt rule in GNI* terms, excluding parts of corporation tax receipts in assessing domestic compliance with the rules and using different estimates of potential growth. My Department will shortly publish an analysis setting out the shortcomings of the rules and outline proposals for improvements. My*

> *intention is to give consideration to some of these and to make recommendations to Government in the autumn."*

The Council welcomes these commitments. However, they should build on all of the four elements set out by the Council as being important for improving budgetary planning in Ireland.

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